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ZNR UUUUU ZZH
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FM AMEMBASSY ISLAMABAD
TO RUEHC/SECSTATE WASHDC 9998
INFO RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDO/DEPT OF COMMERCE WASHINGTON DC
RUEHML/AMEMBASSY MANILA 3072
RUEHBUL/AMEMBASSY KABUL 9373
RUEHNE/AMEMBASSY NEW DELHI 4000
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RUMICEA/USCENTCOM INTEL CEN MACDILL AFB FL
RHMFISS/CDR USCENTCOM MACDILL AFB FL
RUEAIIA/CIA WASHDC
RUEKJCS/SECDEF WASHINGTON DC

UNCLAS SECTION 01 OF 02 ISLAMABAD 003558

SENSITIVE
SIPDIS

E.O. 12958: N/A

TAGS: [ECON](#) [EFIN](#) [ETRD](#) [PREL](#) [PGOV](#) [PK](#)

SUBJECT: CENTRAL BANK RAISES RATES TWO PERCENT AMID BLEAK ECONOMIC
OUTLOOK

11. (SBU) SUMMARY. The State Bank of Pakistan (SBP) Governor, Dr. Shamshad Akhtar, announced that the policy rate would be raised 200 basis points, from 13 percent to 15 percent, presumably in acceptance of International Monetary Fund (IMF) conditionality. However, Akhtar warned banks not to raise the lending rates further because current rates already rose in anticipation of the rate increase. The foreign exchange reserves of the SBP rose slightly, to USD 3.545, but can finance imports of only 29 days. The Adviser on Finance painted a dismal picture of the economy, including 3 percent GDP growth rate, and described the IMF as the only choice to support Pakistan's balance of payments. Just released data show that inflation continued to soar at 25 percent between July and October despite reductions in international commodity prices largely due to latent oil and food price effects. Import growth slowed to 2.4 percent in October with a 10.2 percent rise in exports. If sustained, this trend could reduce the record high trade deficit of USD 7.52 billion in July-October 2008. Remittances increased by 12.7 percent in July-October 2008 but the Money Changers Association warned that investigations of exchange companies for illegal cross border transfer of millions of dollars may negatively affect future remittance inflows. END SUMMARY.

INCREASE IN INTEREST RATES

12. (SBU) On November 12, SBP Governor Akhtar announced in a live teleconference that the discount rate will be raised 200 basis points, from 13 percent to 15. The IMF has advised the policy rate should be raised by 350 basis points to bring rates closer to positive real terms. The November 5 T-bill auction outcome made it clear that the SBP was set to raise the policy rate in accordance with IMF conditionality. In the auction, SBP permitted the yield on 3-month T-bills to rise by 97 basis points to 13.53 percent. Addressing bankers and industrial leaders at the SBP Head Office on November 11, Akhtar warned the banks not to raise lending rates from the current levels, otherwise, SBP would be compelled to either mandate the Karachi Inter-bank Offer Rate or else abolish the system altogether. According to participants, the consensus was that banks have already priced in the expected 200 basis raise in SBP policy rate in anticipation of IMF conditionality. Therefore, SBP wants banks to refrain from raising it further when the discount rate goes to 15 percent. Meanwhile, industry representatives have complained that the mark-up rates are making the industrial sector uncompetitive. They argued that if rates must rise, it should be done gradually.

ECONOMIC INDICATORS CONTINUE DOWNWARD TREND

13. (SBU) On November 10, the Federal Bureau of Statistics reported inflation and trade statistics for October 2008. The State Bank's current foreign exchange reserves of USD 3.545 billion raised slightly, but can finance imports for only 29 days. The consumer price inflation edged up to 25 percent in October, nearing a three-decade high, driven by 31.7 percent food inflation, against 9.31 percent in the same month last year. Even the non-food/non-energy inflation was in double digits at 18.3 percent in October 2008. The consumer price inflation in July-October 2008 was up 24.64 percent year over year. Food inflation moderated a little bit from the July-August figure of 34 percent, though it was still high at 32.3 percent in July-October 2008 compared to 11.2 percent in the same period last year. The non-food/non-energy inflation was 16.7 percent in this period. The government has projected a 12 percent inflation target for 2008-09, which seems highly unlikely to be achieved.

14. (SBU) Imports continued their upward trend and increased by 24.86 percent to USD 14.28 billion year over year in July-October 2008. While import growth slowed 2.45 percent in October compared to last October, it is not significant compared to the plunge in international commodity prices. Exports increased by 16.62 percent year over year in July-October 2008, while their growth rate slowed down to 10.24 percent in October. Eid festival and fewer working days may have affected the exports growth in October. The export growth rate, however, has exceeded the import growth rate in October 2008; if this trend is sustained then the trade deficit may

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decrease. The trade deficit was USD 7.52 billion in July-October 2008, up 33.3 percent year over year. The trade deficit, however, narrowed to USD 1.94 billion in October, compared with USD 2 billion in October last year - a decline of 2.91 percent. Prime Minister Syed Yousuf Raza Gilani has already constituted a high-powered committee, headed by the State Minister for Finance, Hina Rabbani Khar, to monitor the flow of imports into the country and to also suggest measures for moderating them.

15. (SBU) Remittances by overseas Pakistanis kept up their rising trend as USD 2.34 billion was received during July-October 2008, an increase of 12.71 percent (USD 264.5 million), over the same period last year. The monthly average remittances for this period is USD 586.50 million as compared to USD 520.37 million for the same period of last year.

MINISTER PAINTS BLEAK OUTLOOK

16. (SBU) On November 11, while briefing the Senate Shaukat Tareen, Advisor to the Prime Minister on Finance, reflected this dismal picture of the economy. He said inflation has reached 25 percent, the rupee has depreciated over 30 percent, and economic growth has decelerated to 3 percent. In the wake of all these factors, he asserted Pakistan has also lost the support of its economic partners. He said the country has become very weak institutionally and whatever planning was done during the previous government was without foundation. Insufficient emphasis was placed on production and improving the agriculture sector, though 66 percent of Pakistan's population is affiliated with agriculture. This resulted in increased imports and an extra burden on reserves.

17. (SBU) Tareen said that Pakistan has decided to approach the IMF in the next 10 to 15 days. He said that the country needs an inflow of USD 5 billion immediately to manage the balance of payments. "If Friends of Pakistan and other IFIs could not help us within the stipulated period then we have no option except IMF." Tareen stressed the need to strengthen macroeconomic indicators to control inflation and ensure sustainable growth. To achieve these targets, he said, the tax to GDP ratio will have to be increased to 15 percent from 10.5 percent within the next five to seven years.

CRACK DOWN ON MONEY EXCHANGERS CONTINUES

18. (SBU) The SBP also warned exchange companies that any exchange company found to be in violation of SBP rules and regulations in general and any undocumented transactions in particular, would lead to strict action including suspension or cancellation of their license. On October 10, the SBP suspended the license of the Khanani and Kalia International (KKI) foreign exchange company after the arrest of its owners on charges of illegally transferring millions of dollars abroad. The license of the firm, KKI was suspended for 30 days for violating rules and regulations and its head office, branches, franchises, payment booths and currency exchange booths were debarred from undertaking any business during the period.

19. (SBU) Advisor to the Prime Minister on Interior, Rehman Malik disclosed to the Senate on November 11, that just one computer revealed illegal transactions of Rs 39 billion (USD 485 million at 80.35 rupees per USD) by KKI. Approximately twenty such computers have been confiscated. He said they had developed a parallel internet banking system, traces of which were found in Gujranwala, where computers were confiscated following the detection of an informal banking website. Though data was deleted, the cyber crime investigators retrieved it. The investigation continues and more people could be implicated. The president of the Forex Association of Pakistan, Malik Bostan, said the action against the country's biggest exchange company would hurt remittances from overseas Pakistanis, which were expected to reach USD 7 billion by the end of June 2009. Mr. Bostan said SBP should help resolve the issue.

PATTERSON